THE TAX-EXEMPT FINANCING OF STUDENT LOANS

The Congress of the United States
Congressional Budget Office

PREFACE

Since 1968, the federal government has adopted several measures to curb the use of tax-exempt bonds by states and municipalities to finance loans to individuals or private businesses. The most recent of these measures was the Deficit Reduction Act of 1984, which placed limits on the volume of tax-exempt student loan and industrial revenue bonds that states could issue. The act also required the Congressional Budget Office (CBO) and the General Accounting Office (GAO) to conduct independent studies of "the appropriate role" of tax-exempt bonds in federally guaranteed student loan programs and "the appropriate arbitrage rules for such bonds." As specified in the legislation, this report is being submitted to the Committee on Finance and the Committee on Labor and Human Resources in the Senate and the Committee on Ways and Means and the Committee on Education and Labor in the House of Representatives. The report analyzes the use of student loan bonds under current law, the arbitrage earnings that accrue to issuers of these bonds, and the costs to the federal government of tax-exempt financing. In accordance with CBO's mandate to provide objective analysis, it offers a number of alternatives for changing current law, but no recommendations.

The study was made by Pearl W. Richardson of CBO's Tax Analysis Division, under the direction of Rosemary D. Marcuss and Eric J. Toder. Eric Toder wrote the appendix to the report, which provides the analysis underlying CBO's estimates of revenue losses to the federal government from using tax-exempt student loan bonds. Frederick C. Ribe of the Fiscal Analysis Division also contributed importantly to CBO's efforts to estimate revenue losses from tax-exempt financing.

Many others contributed to the study. The state student loan authorities and the Department of Education were most cooperative. Others who provided useful information and helpful comments included Harry Apfel, Loren Carlson, Bruce Davie, H. Benjamin Hartley, Thomas Neubig, David Reicher, James M. Verdier, and Jillian Watkins. Within CBO, constructive comments were made by Michael Deich, Edward M. Gramlich, Robert Hartman, Deborah Kalcevic, Maureen McLaughlin, and Marvin Phaup.

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SUMMARY

In recent years, the federal government has taken measures to limit the volume of bonds that are exempt from federal taxation and are issued by states and municipalities to finance below-market-interest-rate loans to individuals or businesses. This effort has included placing limits on the use of tax-exempt bonds as a source of financing for federally guaranteed student loans. In 1980, the Congressional Budget Office (CBO) found that state and local student loan authorities were earning millions of dollars in profits from the issuance of tax-exempt bonds. The Congress responded by passing legislation to reduce student loan authorities' profits and to lower the costs of using tax-exempt student loan bonds. This report focuses on developments since 1980.

Student loan bonds are issued by state and local student loan authorities to raise funds at rates lower than those available to commercial lenders. The interest rate that students pay on their loans, however, is set by federal legislation and is unaffected by the source of financing. For many years, the federal government has induced commercial lenders to make guaranteed student loans at below-market interest rates by offering them interest subsidies (called "special allowance" payments) and insuring the loans against default. Even with these inducements, however, banks have at times been reluctant to lend because of the high cost of servicing student loans and the lack of an adequate secondary market for the loans. In some instances, then, tax-exempt bonds have made loan funds available where they might otherwise not have been.

Over the years, the links between tax-exempt financing and the issuance of federally guaranteed student loans have raised many questions, such as:

- o To what extent does tax-exempt financing increase the availability of the guaranteed student loans?
- o Are controls on tax-exempt student loan bond issues desirable?

- Are state authorities realizing profits from operating student loan programs? If so, how might these profits be eliminated without destroying or substantially limiting the authorities' ability to operate?

- How costly are student loan bonds? Is tax-exempt financing more costly to the federal government than conventional financing?

THE PRESENT SITUATION

Today, more than 50 authorities in 39 states, the District of Columbia, and Puerto Rico issue student loan bonds and relend the proceeds to students or purchase guaranteed loans made by commercial banks. The number of state authorities issuing student loan bonds more than doubled between 1980 and 1985. Since 1983, however, the volume of new issues of student loan bonds has declined as a result of federal efforts to curb tax-exempt financing. The volume of new issues peaked at $3.1 billion in 1983, declined to $1.4 billion in 1984, and was $2.9 billion in 1985.

Profits on bond issues are lower now than they were in the late 1970s, but under some circumstances they may still far exceed the needs of the state authorities operating student loan programs. The profits accruing to the state authorities are the difference between the yield on student loans and the level of associated expenses. The authorities receive student loan interest payments and special allowance payments from the federal government. Their expenses include interest on the bonds, loan servicing costs, and operating costs. Since few authorities receive state or local appropriations, their income must be sufficient to cover expenses, but it need not exceed expenses.

In most cases, financing student loans through tax-exempt bonds is more costly to the federal government than other means of financing. The cost stems primarily from reduced federal revenues, because interest on the bonds is not subject to federal taxation. When tax-exempt bonds substitute for conventional financing, federal costs are generally higher for a given volume of student loans. If tax-exempt financing results in additional funding, federal costs will be higher but more credit will be available to students.

THE LEGISLATIVE BACKGROUND

Federal law generally prohibits states from issuing tax-exempt bonds at low interest rates and investing the proceeds at much higher yields. Profits that arise in this way are called "arbitrage." Arbitrage profits provide indirect, off-budget subsidies to state governments at the federal taxpayer's expense.

In the Tax Reform Act of 1976, the Congress made an exception for issuers of student loan bonds to the general prohibition against arbitrage. For arbitrage purposes, the special allowance payment on student loans is not counted in determining the yield on the investments made with bond proceeds. At the time the Tax Reform Act of 1976 was enacted, the portion of the return on student loans that was excluded from arbitrage yield calculations (the special allowance payment) was capped under the education laws at 3 percent. Subsequent higher education legislation changed the way the special allowance is calculated and removed its ceiling.

The Middle Income Student Assistance Act of 1978 made all students, regardless of family income, eligible for in-school interest subsidies on their loans. This increased the demand for student loans by students from high-income families. Current law now sets income limits for guaranteed student loans, but these are high enough to assure strong demand for loans.

Although the Congress had no such intention, the interaction of the Tax Reform Act of 1976, the Middle Income Student Assistance Act of 1978, and high interest rates made it possible for state authorities to realize huge profits from tax-exempt financing of student loans. The profits came primarily from the special allowance that the federal government pays to lenders. Once the Congress became aware of the situation, it took action to reduce these profits and subsequently to limit the use of student loan bonds.

The Education Amendments of 1980 cut in half the special allowance paid on loans originating from or purchased with the proceeds of tax-exempt bonds. The Student Loan and Technical Amendments Act of 1983 required that authorities issue no more bonds than were necessary to meet the need for student loan credit in their areas. Subsequent regulations issued by the Department of Education stipulated that student loans financed with tax-exempt bonds would be eligible for special allowance payments only if taxable financing was demonstrably infeasible. Finally, the Deficit Reduction Act of 1984 set limits on the volume of student loan bonds.

THE POTENTIAL EFFECTS OF PENDING LEGISLATION

At present, legislation to reform the tax code and to reauthorize the Higher Education Act of 1965 is pending in both the House and the Senate. In general, pending education legislation would facilitate tax-exempt financing of student loans, while some pending tax reform measures could have the opposite effect. Despite these differences, all of the bills now pending indicate that, in one form or another, the Congress seeks to continue the use of tax-exempt student loan bonds.

If enacted, the education legislation now pending would encourage tax-exempt financing because:

- It would no longer be necessary for state authorities to obtain the approval of the Department of Education in order for loans financed with tax-exempt bonds to be eligible for special allowance payments.

- The bill passed by the Senate would lower the special allowance by one half of a percentage point, which might make it more difficult for authorities to obtain taxable financing. A significantly lower special allowance might also make banks more reluctant to make student loans.

The tax legislation passed by the House would affect student loan bonds in two ways: it would set new, more restrictive limits on the volume of bond issues, and it would tighten arbitrage regulations for all tax-exempt bonds. The new regulations would make it impossible to use arbitrage profits to pay for the costs of bond issuance. The bill passed by the Senate retains the volume limits in current law and, while it imposes new arbitrage restrictions on all bonds, an exception for student loan bonds would make it possible to recover issuance costs from arbitrage profits.

The interaction of some of the provisions of the education and tax bills could make it difficult for state authorities to continue financing loans from tax-exempt or taxable sources. This could happen if, for example, the special allowance is reduced, making taxable financing less feasible, and at the same time stringent arbitrage restrictions are enacted, making tax-exempt financing less feasible. The Congress seems to be neither anticipating nor seeking such an effect, any more than it intended the combined effect of education and tax legislation in the late 1970s, but the possibility is no less real.

THE ALTERNATIVES TO CURRENT POLICY

The justification for tax-exempt financing is that it provides funds for student loans that private institutions otherwise would not make available. The extent to which tax-exempt bonds affect loan availability, however, is difficult to quantify. To some degree, they have displaced lending from taxable sources. In some states, however, they seem to have increased the amount of lending either because of the favorable terms state authorities offered in buying loans from banks or because they were willing to lend when banks refused to do so. At the same time, the bonds represent a cost to the federal government, and the potential for student loan authorities to realize sizable surpluses from issuing them is significant, despite the legislation passed in 1980 and the volume limits and administrative controls instituted more recently.

In considering alternatives to current law, the Congress will have to determine whether its primary objective is to increase the availability of student loan credit, to reduce the deficit, or to eliminate student loan authorities' profits.

- If its goal is to increase the availability of student loans, the Congress either could provide additional incentives to commercial banks and thrift institutions by increasing special allowance payments so that more taxable funds become available for GSL and PLUS loans, or it could ease some or all of the present restrictions on tax-exempt financing.

- If the Congress seeks to maximize the amount of student credit available and, at the same time, to reduce off-budget, nonvisible tax expenditures, it could increase the special allowance for taxable loans and eliminate tax-exempt student loan bonds entirely.

- If the Congress wants to lower the deficit, it might consider reducing the special allowance payments for student loans and either imposing additional limits on the use of student loan bonds or eliminating them entirely and reducing the overall volume limits on tax-exempt bonds accordingly.

- If the Congress's main aim is to eliminate student loan authorities' profits, it might consider lowering the special allowance payment for student loans financed with tax-exempt bonds or tightening the arbitrage provisions of current law by including special allowance payments in calculations of arbitrage income and requiring student loan authorities to rebate arbitrage earnings to the federal government. The Congress could also specify permissible uses of surplus funds resulting from student loan authority operations.

Some of these measures are not mutually exclusive. For example, the Congress could ease the volume limits or retain current limits and, at the same time, tighten the arbitrage regulations for student loan bonds; or, it could impose more restrictive volume limits and tighten arbitrage regulations. The action that the Congress ultimately takes would depend on whether its primary concern is the overall level of tax-exempt financing, the potential enrichment of state student loan authorities at the federal taxpayers' expense, or both.

CHAPTER I

INTRODUCTION

For the past several years, the federal government has attempted to curb tax-exempt financing in general and student loan bonds in particular. This report deals with past, current, and potential issues stemming from the use of tax-exempt bonds as a source of financing for federally guaranteed student loans. Its purpose is to satisfy the provisions of the Tax Reform Act of 1984, requiring the Congressional Budget Office to study "the appropriate role" of tax-exempt bonds in federally guaranteed student loan programs and "the appropriate arbitrage rules for such bonds."

Student loan bonds are a unique form of tax-exempt financing because they are integrally related to other federal programs that provide direct subsidy assistance, namely, the Guaranteed Student Loan (GSL) and the Parent Loans for Undergraduate Students (PLUS) programs. A CBO report published six years ago examined some of the issues that grew out of the relationship between tax-exempt financing and direct federal assistance for higher education loan programs.1/ In 1980, CBO found that state student loan authorities were earning millions of dollars in profits from the issuance of tax-exempt bonds. The Congress responded by passing legislation intended to reduce student loan authorities' profits and to lower the costs of using tax-exempt student loan bonds. This report examines the effectiveness of that legislation in the light of subsequent developments. Accordingly, it focuses on federal revenue losses from tax-exempt student loan bonds and on the arbitrage earnings that accrue to state authorities when they issue tax-exempt bonds and invest the proceeds at much higher yields, a practice that federal income tax law generally prohibits because it results in indirect, off-budget subsidies to state governments at the federal taxpayer's expense.

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1. Congressional Budget Office, *State Profits on Tax-Exempt Student Loan Bonds: Analysis and Options* (March 1980).

THE GSL AND PLUS PROGRAMS

The Guaranteed Student Loan Program, enacted in 1965, has been the primary source of student loan assistance for higher education for the past 20 years. Students qualify for GSLs if they are enrolled at least half time in an eligible institution of higher education or a vocational school. Undergraduates may borrow up to $2,500 a year and $12,500 over five years. Graduate students may borrow up to $5,000 a year, limited to a total of $25,000 for all undergraduate and graduate indebtedness under the program.2/ Students whose families' adjusted gross income is less than $30,000 a year may borrow the difference between their education costs and any other aid, up to the annual maximum. Students whose families' annual income exceeds $30,000 may borrow the dollar limit only if it is less than the difference between the cost of attendance and the estimated expected family contribution, which is based on adjusted gross income, and other aid.3/

Under the GSL program, the Department of Education subsidizes student loans in three ways:

- o It guarantees repayment of qualified student loans.
- o It provides lenders with an interest subsidy on qualifying student loans in the form of a quarterly special allowance payment. This makes it possible for student borrowers to pay less interest.
- o It pays an additional interest subsidy while the student is attending school. The student neither pays nor accrues interest or principal while in school. In effect, the in-school interest subsidy is a grant because the student never has to repay it.

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2. Pending legislation in both the House and the Senate would increase annual and aggregate loan limits. H.R. 3700 would raise loan limits to $5,000 a year for juniors and seniors, up to a total undergraduate indebtedness of $14,500, and to $8,000 a year for graduate students, if their tuition, fees, and costs exceed $5,000 a year, up to a maximum for all undergraduate and graduate indebtedness under the program ranging from $39,500 to $64,500. S. 1965 would increase annual loan limits to $3,000 for freshmen and sophomores, $4,000 for juniors and seniors, and $7,500 for graduate students. Undergraduates would be able to borrow up to $18,000 over five years, and graduate students would be able to incur a debt of up to $50,000 for all undergradute and graduate loans.

3. Both H.R. 3700 and S. 1965 would base assistance on a needs analysis for all students, regardless of income. Dependent students from high-income families would be eligible for assistance under a supplemental loan program, which would provide shallower subsidies than the regular GSL program.

The PLUS program, enacted in 1980, is similar, but the loans are available only to parents and students who are not dependent on their parents. The interest rates to borrowers are higher and interest payments are made while the student is in school, making the federal subsidy considerably less.

FINANCING STUDENT LOANS

Commercial banks, nonprofit state and local authorities, the Student Loan Marketing Association (Sallie Mae), and other lenders make and purchase loans under the GSL and PLUS programs. Sallie Mae was established in 1972 to increase the availability of student loans by providing funds to lenders. Sallie Mae does so by selling its debt to investors and using the proceeds to buy GSL and PLUS loans from banks, savings and loans, and state authorities, and by making loans, known as warehousing advances, to these institutions. Sallie Mae does not originate loans, but through its loan purchases and warehousing advances combined, Sallie Mae provides funding for about one-third of all outstanding guaranteed student loans. The relationship between Sallie Mae and state authorities is complex. Sallie Mae may be a competitor, a creditor, or a customer of any single authority--or it may be all three. Sallie Mae competes with state authorities that buy loans from banks and thrift institutions; it may provide warehousing advances to authorities to finance either their direct lending or their secondary market activities; and it may buy loans from authorities.

State and local authorities use the proceeds of tax-exempt student loan bonds and, to a lesser extent, taxable loans from Sallie Mae or other institutions to finance their direct lending and secondary market activities. As of the end of fiscal year 1985, state and local authorities held about 12 percent of the $39 billion in loans outstanding under the GSL and PLUS programs. Sallie Mae held 16 percent.

At present, the interest rates to student loan borrowers are 8 percent under the GSL program and 12 percent under the PLUS program. In the past, interest rates on GSL loans have ranged from 7 to 9 percent, while PLUS rates have been as high as 14 percent. These rates are set by legislation.4/ The Department of Education gives lenders a special allowance

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4. H.R. 3700 would raise interest rates on new loans to 10 percent five years after the student has left school. S. 1965 would raise the interest rate to 10 percent as soon as the student begins to repay the loan.

payment (SAP) that fluctuates with the Treasury bill rate and makes up the difference between the interest rate that students pay and the interest that banks could earn on alternative investments. The SAP brings the rate on the loans up to 3.5 percentage points above the bond equivalent rate of the 91-day T-bill.5/ The special allowance on loans made with the proceeds of tax-exempt bonds is 50 percent lower than on loans from commercial banks because the cost of borrowing with tax-exempt bonds is lower.

When students borrow under the GSL and PLUS programs, the interest rates they pay are the same regardless of whether the financing is taxable or tax-exempt. The rationale for tax-exempt financing is not that it makes it possible for students to get guaranteed loans at lower rates, but that it increases access to student loans by making it possible for state and private nonprofit authorities to operate wherever private institutions may be reluctant to do so.

KEY ISSUES

Over the years, the links between tax-exempt financing and the GSL and PLUS programs have raised a number of special issues. The primary questions have been:

- What is the role of tax-exempt financing in view of the many sources of conventional financing available to carry out the purposes of the GSL and PLUS programs? Does tax-exempt financing increase the availability of loan funds?

- Are controls on tax-exempt student loan bond issues desirable?

- Are state authorities realizing profits from operating student loan programs?

- Is tax-exempt financing of student loans more costly to the federal government than taxable financing?

This study attempts to address these issues. The chapters that follow cover the history of tax-exempt student loan bonds, their interaction with

5. S. 1965 would reduce the SAP, making the rate on loans 3.00 percentage points above the bond equivalent 91-day T-bill. The bond equivalent rate is slightly higher than the actual T-bill rate.

student loan programs, and the issues they have raised; the effects of recent efforts to limit the use of student loan bonds; the operations of state and local student bond programs; the costs to the federal government of student loan bonds; and the alternatives to current policy.

The report also looks at the potential effects of pending legislation on tax-exempt student loan bonds, the authorities that issue them, and student loan financing generally. Its aim is to provide the Congress with the information it needs to determine whether or not legislation governing student loan bonds should remain the same or be changed and, if so, how. In light of its Congressional mandate, the report does not consider the larger issues of subsidies for higher education, the need for them, or the best ways of providing them. Rather, it assumes that the Congress has already determined that assistance for higher education should be provided primarily through federal grants and guaranteed loans to students.

In undertaking this study, CBO reestimated revenue losses from tax-exempt bonds. A technical appendix to the report describes in detail the model used to estimate these losses.